
PRIMER ON B&I BASICS

Business & Industry (B&I) Guaranteed Loan Program

The attached pages provide an overview of several of the most important, yet frequently misunderstood features of the B&I program:

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TANGIBLE BALANCE SHEET EQUITY TEST

Reference: RD Instruction 4279-B, Section 4279.131(d)

One of the key financial ratios in qualifying for B&I assistance is tangible balance sheet equity. USDA analyzes the overall equity-to-asset ratio of the business on a pro forma basis to decide whether there is adequate solvency in the business. The following rules apply when calculating a business's tangible balance sheet equity:

1. This is a *pro forma* test of the business's equity position. This means it requires a projection of the applicant's balance sheet once the B&I-funded project is complete -- i.e., the B&I loan is listed as a liability and assets being acquired are also reflected.
2. Only *business assets* are included in the analysis. This is generally straightforward if the applicant is a corporation or partnership. When individuals are applying, personal assets, such as their home and assets not directly connected with the business, must be excluded.
3. The test is based on cost, not market values. The *depreciated book value of assets* is used in this test. Thus, *appraisal surplus cannot be used* to satisfy equity requirements. Remember, this is not a collateral test.
4. In performing this test, USDA considers *only the tangible assets* of the business. Intangible assets are excluded from consideration. Intangible assets include:
 - Expense "assets" -- e.g., advertising, amortization costs, organizational costs, financing expenses, development expenses, exploration expenses, R&D expenses
 - Contracts -- e.g., franchises, licenses, publishing rights
 - Goodwill
 - Mailing lists, subscription lists
 - Patents, copyrights
 - Proprietary rights -- e.g., blending rights, bookplates, bottling rights, designs, dies, drawings, formulas, models, patterns
 - Trade names, brand names, labels
 - Items without tangible value -- e.g., bond discounts, catalogs, debenture discounts
5. *Only true equity* counts toward this test. *Subordinated debt and deferred loans are not considered equity.* (Subordinated debt may be converted into stock to meet this requirement however.) In essence, the primary sources of tangible balance sheet equity are cash, paid-in equity investments, and retained earnings.
6. Established businesses need a minimum of 10% tangible balance sheet equity. New and emerging businesses need a minimum of 20% tangible balance sheet equity.

The attached worksheet may be used to compute tangible balance sheet equity. This worksheet or some comparable table should be included with every B&I preapplication.

Pro Forma Tangible Balance Sheet Equity Analysis

Recommended format for calculating pro forma tangible balance sheet equity.

Instructions:

1. Attach the current balance sheet from which the "Beginning Position" (column 1 below) figures are taken. Be sure that the "Beginning Position" values are based on depreciated book value (cost), not current market values. If the applicant's balance sheet is not prepared on a cost basis, provide an attachment explaining adjustments made to derive cost basis figures.
2. Deduct intangible assets (columns 2 & 3). Itemize intangible assets deducted in the explanation section below the table.
3. Debt and credit assets and liabilities (columns 4, 5, & 6) to reflect the effect of the B&I financing. Itemize debits and credits in the explanation section below the table.
4. Divide pro forma tangible equity by pro forma tangible assets to determine % equity position.

Applicant: _____

Derived from Balance Sheet (attached) as of: _____

	Beginning Balance Sheet Position	<i>less</i> Intangible Assets ¹	<i>equals</i> Tangible Beginning Position	<i>plus</i> Debits ²	<i>less</i> Credits ³	<i>equals</i> Pro Forma Tangible Position
Total Assets						
Total Liabilities						
Equity						
%Equity =						

¹ Itemize intangible assets:

² Itemize debits:

³ Itemize credits:

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(d) Equity. A minimum of 10 percent tangible balance sheet equity will be required for existing businesses at the time the Loan Note Guarantee is issued. A minimum of 20 percent tangible balance sheet equity will be required for new businesses at the time the Loan Note Guarantee is issued. Tangible balance sheet equity will be determined in accordance with Generally Accepted Accounting Principles. Modifications to the equity requirements may be granted by the Administrator or designee. For the Administrator to consider a reduction in the equity requirement, the borrower must furnish the following:

(1) Collateralized personal and corporate guarantees, including any parent, subsidiary, or affiliated company, when feasible and legally permissible (in accordance with § 4279.149 of this subpart), and

(2) Pro forma and historical financial statements which indicate the business to be financed meets or exceeds the median quartile (as identified in Robert Morris Associates Annual Statement Studies or similar publication) for the current ratio, quick ratio, debt-to-worth ratio, debt coverage ratio, and working capital.

(3) *The Agency may require higher equity requirements if conditions warrant. As a loan officer, you will expect to see tangible balance sheet equity meeting at least the minimum requirement unless an exception is granted by the Administrator or designee. Riskier loans such as startups, recreation and tourism projects, energy-related businesses and loans without personal guarantees may necessitate a higher equity requirement than the minimum equity requirements noted above. Solid equity positions provide incentive for principals to remain committed to the success of the applicant while reducing the debt burden.*

TANGIBLE BALANCE SHEET EQUITY TEST
Exercise

A \$1,000,000 working capital loan is proposed for an established fertilizer manufacturing company. Its current balance sheet looks like this:

Fertilizer Company			
Balance Sheet as of 12/31/XX			
Cash		\$ 300,000	
Accounts receivable			
<90 days	\$200,000		
>90 days	\$ 20,000		
From officers	\$ 10,000		
Bad debt	< 0>		
		\$ 230,000	
Inventory		\$ 400,000	
CURRENT ASSETS			\$ 930,000
Machinery & equipment (less depreciation)		\$ 200,000	
Real estate improvements (less depreciation)		<u>\$ 800,000</u>	
FIXED ASSETS			\$1,000,000
Trade Name		\$ 40,000	
Organization Costs		<u>\$ 30,000</u>	
OTHER ASSETS			<u>\$ 70,000</u>
TOTAL ASSETS			<u>\$ 2,000,000</u>
Accounts Payable	\$ 200,000		
Current Portion Long-Term Debt	\$ 300,000		
Accrued Liabilities	<u>\$ 300,000</u>		
CURRENT LIABILITIES			\$ 800,000
Note Payable to Owner	\$ 800,000		
Deferred Tax	<u>\$ 200,000</u>		
LONG-TERM LIABILITIES		<u>\$1,000,000</u>	
TOTAL LIABILITIES			\$ 1,800,000
NET WORTH			<u>\$ 200,000</u>
TOTAL LIABILITIES & NET WORTH			<u>\$ 2,000,000</u>

Will this business pass the tangible balance sheet equity test?

TANGIBLE BALANCE SHEET EQUITY TEST

Answer to Exercise

Step 1: Adjust for Intangible Assets

The balance sheet reflect a 10% equity-to-asset ratio. On its face, the business meets the equity test for an established business (though not for a new business). However, closer inspection of the balance sheet's asset shows that intangible assets are included:

Trade Name	\$ 40,000
Organization Costs	<u>\$ 30,000</u>
Intangible Assets	\$ 70,000

These must be deducted to arrive at the value of the business's tangible assets:

Total Assets	\$ 2,000,000
LESS Intangibles	<u>- 70,000</u>
Tangible Assets	\$ 1,930,000

The beginning equity position changes as a result:

Tangible Assets	\$ 1,930,000
LESS Total Liabilities -	<u>1,800,000</u>
Tangible Net Worth	\$ 130,000 (6.7%)

Step 2: Adjust for Pro Forma Changes

The B&I project involves the injection of \$1,000,000 of working capital and the addition of \$1,000,000 of liabilities. The fees and costs connected with the B&I loan will cost the company \$25,000 of its working capital. Thus, on a pro forma basis, the balance sheet will show:

Tangible Assets Before Project	\$ 1,930,000	
PLUS B&I Loan's Working Capital	+ 1,000,000	
LESS Loan Fees and Costs	<u>- 25,000</u>	
Pro Forma Tangible Assets		\$ 2,905,000
 Total Liabilities Before Project	 \$ 1,800,000	
B&I Loan	<u>+ 1,000,000</u>	
Pro Forma Liabilities		<u>\$ 2,800,000</u>
 Pro Forma Net Worth	 \$ 105,000 (3.6%)	

Thus, the business will not meet the tangible balance sheet equity requirement. The business needs at least \$290,500 in equity (10%), but has only \$105,000 -- i.e., they are \$185,500 short.

However, all is not necessarily lost. Two solutions to the dilemma are possible:

1. The owner could inject an additional \$185,500 into the business, either from profits or from outside cash investment, and reduce the B&I loan amount by a corresponding amount, i.e. to \$814,500. This would result in desired \$1,000,000 increase in working capital, with a net worth of \$290,500 (10%).
2. The owner could convert the note payable owed him by the business into stock. This would have the effect of decreasing liabilities by \$800,000 and increasing net worth by the same amount. The business's tangible net worth would soar to \$905,000 (31.2%).

ADEQUATE COLLATERAL TEST

Reference: RD Instruction 4279-B, Section 4279.131(b) & (e)

USDA looks to the lender to **assure that loans are fully secured**. USDA does a review the proposed collateral for the loan to satisfy itself that the security will be adequate.

In establishing collateral value, **the value of the collateral is discounted by a factor**. USDA Rural Development-California considers the following discounts to be in keeping with sound loan-to-value policy:

- Real estate: Normally 80% of the current appraised value, though single-use properties may be less.
- Chattels: 80% or less of the current appraised value. 60-70% will be typical.
- Inventory: 60% or less of book value. Normally less.
- Accounts receivable: 60% or less of book value. Normally less. Exclude all A/R over 90 days past due; exclude all A/R from owners, officers, employees, or affiliates.
- Personal guaranties: No value is given to them in this test.
- Insurance: No value is given to insurance in this test.

Additional factors used in determining the discount factor:

- Lien position
- The marketability of the collateral
- The degree to which the collateral is highly specialized, unique, or single purpose --
e.g., off-the-shelf items from national manufacturers will be less heavily discounted
- The extent to which the collateral tends to wear out or depreciate rapidly --
e.g., vehicles and furnishings will be more heavily discounted
- The age and condition of the collateral

Loans to acquire real property or chattels. The value attributed to the assets being acquired is included in the calculation.

Working capital loans. these loans must be adequately secured based on assets already owned by the business. The value of inventory and accounts receivable to be acquired with such loans will normally not be considered.

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(b) Collateral.

(1) Collateral must have documented value sufficient to protect the interest of the lender and the Agency and, except as set forth in paragraph (b)(2) of this section, the discounted collateral value will normally be at least equal to the loan amount. Lenders will discount collateral consistent with sound loan-to-value policy.

(2) Some businesses are predominantly cash-flow oriented, and where cash flow and profitability are strong, loan-to-value coverage may be discounted accordingly. A loan primarily based on cash flow must be supported by a successful and documented financial history.

(3) *Do not reject B&I applications automatically when weak collateral is the only unfavorable factor. Other factors, such as a strong indication of repayment ability and managerial ability, can offset this deficiency.*

(4) *Make sure that all worthwhile collateral is pledged to the project, but do not require assets with little or no collateral support to be pledged mainly for cosmetic reasons.*

(e) Lien priorities. The entire loan will be secured by the same security with equal lien priority for the guaranteed and unguaranteed portions of the loan. The unguaranteed portion of the loan will neither be paid first nor given any preference or priority over the guaranteed portion. A parity or junior position may be considered provided that discounted collateral values are adequate to secure the loan in accordance with paragraph (b) of this section after considering prior liens.

ADEQUATE COLLATERAL TEST
Exercise

A \$1,000,000 working capital loan is proposed for an established fertilizer manufacturing business. The security will consist of a first lien on:

The 10-acre manufacturing facility, with a current appraisal indicating a fair market value of \$500,000 and a depreciated book value of \$250,000.

The machinery and equipment associated with the operation, with a current appraised value of \$300,000 and a depreciated book value of \$200,000. the appraisal indicates the equipment is in good condition.

Fertilizer inventory with a book value of \$400,000 and a sales value of \$1,200,000.

Accounts receivable totaling \$230,000. This includes \$10,000 receivable from an officer's farm operation and \$20,000 of debt within 90 days past due but which the applicant believes to be collectable.

An assignment on a \$1,000,000 key person life insurance policy, plus hazard insurance in an amount equal to the depreciated replacement value of the real estate and chattels -- \$450,000.

A personal guaranty from the sole owner, whose personal net worth is \$2.5 million, derived primarily from local real estate holdings.

Is there adequate security for the loan?

ADEQUATE COLLATERAL TEST

Answer to Exercise

The collateral test for the proposed loan is shown in the table below:

<u>Collateral Type</u>	<u>Asset Description</u>	<u>Basis for Valuation</u>	<u>Actual Value</u>	<u>Discount</u>	<u>Attributed Collateral Contribution</u>
Real estate	Manufacturing facility	Current appraised value	\$ 500,000	80%	\$ 400,000
Machinery & equipment	Fertilizer plant equipment	Current appraised value	\$ 300,000	70%	\$ 210,000
Inventory	Manufactured fertilizer & raw materials	Book value	\$ 400,000	60%	\$ 240,000
Accounts receivable	A/R excluding A/R > 90 days and A/R from officers	Book value	\$ 230,000 - 10,000 - 20,000 <u>\$ 200,000</u>	60%	\$ 120,000
Insurance	Key person life insurance & Property hazard insurance			No value given in this test	\$ 0
Personal guaranties	Personal guaranty of owner with \$2.5 million net worth			No value given in this test	\$ 0
TOTAL			<u>\$ 1,400,000</u>		<u>\$ 970,000</u>

There is not adequate security for the loan. Either the request must be reduced, or additional collateral must be offered. Perhaps the owner could pledge some of the local real estate which contributes to his \$2.5 million net worth.

FEASIBILITY STUDY REQUIREMENT

Reference: RD Instruction 4279-B, Section 4279.150

USDA may require an independent feasibility study as part of the complete B&I application. USDA has the discretion to decide whether or not such a study is needed.

Feasibility studies are generally required if the project involves:

1. A new business -- e.g., a start-up company
2. An existing business which lacks a profitable history -- e.g., recent losses, weak financial ratios compared to industry averages, etc.
3. An existing business which is proposing to develop an independent operation in a new location -- e.g., a second retail sales outlet which will depend on a new market area for its success

Feasibility studies are generally not required if the project involves:

1. An existing business that has already documented a historic ability to generate sufficient funds to service the proposed loan.
2. A commercial lease facility. In lieu of a feasibility study, the applicant must provide evidence of sufficient committed tenants to assure a break-even operation. The financial strength of the tenants and the length of their lease commitment will also be taken into account.

Who prepares the feasibility study? The study should be prepared by an independent consultant with a recognized expertise in the type of operation being analyzed. Examples of acceptable consultants include industry association consultants, industry experts, local Small Business Development Center consultants, specialized CPA's, and specialty appraisers.

Contents of the feasibility study. Appendix A to RD Instruction 4279-B (reverse) provides a recommended outline of considerations to be included in the feasibility study. Particular emphasis should be given to market feasibility and management feasibility issues.

RD Instruction 4279-B
Appendix A

Guide for Completion of Feasibility Studies

A feasibility study by a recognized independent consultant may be required by the Agency for start-up businesses or existing businesses when the project will significantly affect the borrower's financial operations. An acceptable feasibility study should include, but not be limited to:

(a) Economic feasibility. Information related to the project site; availability of trained or trainable labor; utilities; rail, air, and road service to the site; and the overall economic impact of the project.

(b) Market feasibility. Information on the sales organization and management, nature and extent of market and market area, marketing plans for sale of projected output, extent of competition, and commitments from customers or brokers.

(c) Technical feasibility. Technical feasibility reports shall be prepared by individuals who have previous experience in the design and analysis of similar facilities or processes proposed in the application. The technical feasibility reports shall address the suitability of the selected site for the intended use including an environmental impact analysis. The report shall be based upon verifiable data and contain sufficient information and analysis so that a determination may be made on the technical feasibility of achieving the levels of income or production that are projected in the financial statements. The report shall also identify any constraints or limitations in these financial projections and any other facility or design-related factors which might affect the success of the enterprise. The report shall also identify and estimate project operating and development costs and specify the level of accuracy of these estimates and the assumptions on which these estimates have been based. For the purpose of the technical feasibility reports, the project engineer or architect may be considered an independent party provided neither the principals of the firm nor any individual of the firm who participates in the technical feasibility report has a financial interest in the project, and provided further that no other individual or firm with the expertise necessary to make such a determination is reasonably available to perform the function.

(d) Financial feasibility. An opinion on the reliability of the financial projections and the ability of the business to achieve the projected income and cash flow. An assessment of the cost accounting system, the availability of short-term credit for

seasonal business, and the adequacy of raw materials and supplies.

(e) Management feasibility. Evidence that continuity and adequacy of management has been evaluated and documented as being satisfactory.

B&I ENVIRONMENTAL ANALYSIS

Reference: RD Instruction 1940-G, Sections 1940.310, 311, & 312

As a federal program, all B&I assistance is subject the National Environmental Policy Act (NEPA) and other federal guidelines designed to assure that federally-supported projects do not harm the environment. Consequently, USDA must complete an environmental analysis on all B&I projects.

This analysis is in addition to any environmental review undertaken under the California Environmental Quality Act (CEQA) or in connection with collateral issues (e.g., Phase I or Phase II studies).

The level of USDA environmental review required depends on the nature of the project, ranging from “**Categorical Exclusion**” to “**Class I**” to “**Class II**” -- in order of increasing complexity.

Class II projects, and occasionally Class I projects, require published public notices and public comment periods. The level of review therefore may effect the time needed to complete B&I application processing.

General Predictors for Level of Environmental Review:

☞ *USDA always looks at the overall project being financed, not just the B&I loan purposes.*

Certain projects are nearly always **Categorical Exclusions** (the simplest & fastest review):

- ☞ Debt refinancing
- ☞ Transfer of ownership
- ☞ Working capital
- ☞ Machinery & equipment
- ☞ Acquisition or use of an existing facility (purchase or lease)
- ☞ Building renovation (if the building is less than 50 years old)

Exceptions: surface mining, logging/clearing of 35+ acres. Also, the presence of important resources (e.g., floodplain, prime farmland) may call for a higher level review.

The following projects may be **Class II, Class I, or Categorical Exclusions** depending on project:

- ☞ Expansion of real estate improvements on already-developed land
- ☞ New real estate improvements on undeveloped land
- ☞ Renovation/removal of 50+ year old building

Categorical exclusion, if:

Minimal change in use, size, capacity, purpose, & location of existing facility

Class I, if:

Further development of a previously-developed site

Renovation/removal of 50+ year old building

Development of an undeveloped site when the property is: a small site (generally <5 acres); a city lot; in a built-up commercial area; in an industrial park

Class II, if:

Development of undeveloped site when the property is: a large site (>5 acres); or remote or undisturbed

“Substantial” traffic congestion will be generated

“Substantial” amounts of hazardous/toxic/radioactive/odorous waste will be generated

Aquaculture facility development or expansion

Group home/medical facility adding 25 beds or increasing # of beds by 25%.